

Message Text

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TO SECSTATE WASHDC PRIORITY 2142

C O N F I D E N T I A L SECTION 1 OF 2 LISBON 5345

E.O. 11652: GDS

TAGS: PINT, EFIN, PO

SUBJ: POLITICAL IMPACT OF PORTUGAL'S FOREIGN EXCHANGE CRISIS

SUMMARY: PORTUGAL'S LOOMING FOREIGN EXCHANGE CRISIS
OCCURS AGAINST A BACKGROUND OF MIXED BUT STEADY PROGRESS
TOWARD ECONOMIC RECOVERY AND THE STABILIZATION OF
DEMOCRATIC INSTITUTIONS. THE TIMING OF THE CRISIS COULDN'T
BE MORE INOPPORTUNE. A WORSE-CASE SCENARIO WOULD INCLUDE
THE FALL OF THE SOCIALIST GOVERNMENT AND THE INEVITABLE
POLARIZATION OF PORTUGUESE SOCIETY. BUT DISASTER IS NOT
INEVITABLE; THERE IS STILL RESILIENCY WITHIN THE SYSTEM.
EVEN UNDER THE BEST OF CIRCUMSTANCES, HOWEVER, PROGRESS TOWARD
A STABLE DEMOCRACY WILL BE SET BACK. END SUMMARY.

1. THIS MESSAGE PROVIDES THE POLITICAL BACKDROP AGAINST
WHICH PORTUGAL MUST DEAL WITH ITS LOOMING FOREIGN EXCHANGE
CRISIS. IT REVIEWS THE KEY ENVIRONMENTAL FACTORS, THE
TIMING OF THE CRISIS, AND PRESENTS A PRELIMINARY DAMAGE
ASSESSMENT.

2. REVIEWING THE VARIABLES: IN OUR ANNUAL ASSESSMENT
WE CALLED ATTENTION TO A SERIES OF FACTORS WHICH WILL
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LARGELY DETERMINE THE SUCCESS OR FAILURE OF PORTUGAL'S
EFFORT TO MAKE DEMOCRACY WORK. THE STATE OF PLAY OF
EACH VARIABLE FOLLOWS:

-- THE PACE OF ECONOMIC RECOVERY: PROGRESS IS
BEING MADE. IMMIGRANT REMITTANCES AND TOURISM ARE UP.
THE RULES OF THE GAME ARE BEING DEFINED, BASICALLY TO
THE SATISFACTION OF MOST OF THE BUSINESS COMMUNITY. THE

CONSTRUCTION SECTOR HAS RENEWED BUOYANCY. LABOR DISCIPLINE BEING RESTORED. PRODUCTIVITY IS IMPROVING, ESPECIALLY IN THE NORTH.

-- WILLINGNESS OF OTHERS TO HELP: PORTUGAL'S FRIENDS, PARTICULARLY THE U.S.; THE EUROPEANS, LED BY GERMANY; AND THE JAPANESE ARE COMING THROUGH. THE 15-NATION COMMITMENT TO HELP MADE IN PARIS REPRESENTS A UNIQUE EXPRESSION OF FAITH IN PORTUGAL'S FUTURE.

-- COHESION OF THE SOCIALISTS: THE SOCIALISTS ARE HOLDING TOGETHER DESPITE THE INTERNAL TENSIONS GENERATED BY ASSOCIATION WITH AN UNPOPULAR AUSTERITY PROGRAM. THE THREAT POSED BY FORMER AGRICULTURE MINISTER LOPES CARDOSO AND OTHER PS LEFTWINGERS IS BEING MET HEAD ON. SOARES SAYS LOPES CARDOSO WILL INEVITABLY BREAK WITH THE PARTY BUT WILL CARRY FEW PS DEPUTIES WITH HIM.

-- THE TRADE UNION MOVEMENT: NOT SO PROMISING. DEMOCRATIC LABOR ELEMENTS HAVE THUS FAR BEEN UNSUCCESSFUL IN THEIR EFFORTS TO MOUNT A SERIOUS CHALLENGE TO THE COMMUNIST-DOMINATED CGTP. THE COMMUNISTS CONTINUE TO WIN THE IMPORTANT TRADE UNION ELECTIONS. LABOR MINISTER GONELHA'S STRATEGY FOR REVERSING THE TREND, HOWEVER, IS JUST GETTING STARTED.

-- COOPERATION AMONG THE DEMOCRATIC PARTIES: HIGHLY UNEVEN. THE SOCIAL DEMOCRATS, UNDER SA CARNEIRO'S ERRATIC LEADERSHIP, HAVE VACILLATED BETWEEN EFFORTS TO COOPERATE WITH THE GOVERNMENT AND ATTEMPTS TO REPLACE CONFIDENTIAL

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IT. UNDER PRESSURE FROM THE RIGHT, FREITAS DO AMARAL AND THE CDS HAVE BECOME LESS CONCILIATORY. THE SOCIALIST GO-IT-ALONG STRATEGY HAS BECOME INCREASINGLY DIFFICULT. BOTH THE PSD AND THE CDS WANT TO SHARE THE POWER AND PEROGATIVES OF OFFICE. THE PS NEEDS THEIR HELP TO PASS MAJOR LEGISLATION CURRENTLY BEFORE THE ASSEMBLY. AND THE SOCIALISTS WILL HAVE TO PAY A PRICE TO GET IT.

-- THE COMMUNIST STRATEGY: FACED WITH UNRELENTING GOVERNMENT PRESSURE, PARTICULARLY IN THE RURAL ALENTEJO, THE COMMUNISTS ARE DIGGING IN. CUNHAL HAS THREATENED TO GO TO THE STREETS RATHER THAN ACCEPT THE DISMANTLING OF PCP POWER CENTERS IN THE ALENTEJO.

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C O N F I D E N T I A L SECTION 2 OF 2 LISBON 5345

-- THE ROLE OF THE PRESIDENT: THE PRESIDENT HAS
TURNED IN A REMARKABLE PERFORMANCE DURING HIS FIRST
YEAR IN OFFICE. BUT PRESSURES ARE MOUNTING FOR HIM TO
PLAY A MORE ACTIVE, AND INEVITABLY MORE PARTISAN ROLE.

3. TIMING COULDN'T BE WORSE: THE CURRENT FOREIGN
EXCHANGE CRISIS COMES AT A PARTICULARLY INOPPORTUNE TIME.

-- DESPITE SIGNS OF ECONOMIC RECOVERY, INVESTOR
CONFIDENCE - THE CRUCIAL INGREDIENT - IS STILL LACKING.

-- KEY LEGISLATION CURRENTLY BEFORE ASSEMBLY OFFERS
PROMISE FOR PROMOTING INVESTOR CONFIDENCE AND
INCREASING PRODUCTIVITY. THE GOVERNMENT, HOWEVER, DOES
NOT YET HAVE THE VOTES TO PUT THE MEASURES ACROSS.

-- AZORES NEGOTIATIONS ARE PROCEEDING. BUT A UNIFIED,
SELF-CONFIDENT GOVERNMENT WILL BE NEEDED TO PRODUCE AN
ACCEPTABLE SETTLEMENT AND MAKE IT WORK.

-- ALTHOUGH THE COMMUNISTS ARE BEING TAMED, THEY
RETAIN SIGNIFICANT ASSETS AND ARE READY TO EXPLOIT
TARGETS OF OPPORTUNITY.

-- AS DEMONSTRATED BY THE RECENT "EXPRESSO" POLL,
THERE IS GROWING DISSATISFACTION WITH THE GOVERNMENT BUT
NO CONSENSUS ON DEMOCRATIC ALTERNATIVES.

-- THERE ARE SIGNS OF A RESURGENCE ON THE RIGHT.
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KAULZA DE ARRIJA, MIRN, PAP, AND IOR ARE AGAIN MAKING
NEWS.

-- UNEMPLOYMENT REMAINS HIGH AND PRICES CONTINUE
TO SOAR, FEEDING A MOOD OF GROWING FRUSTRATION AND
IMPATIENCE.

4. A PRELIMINARY DAMAGE ASSESSMENT: CURRENT POLICY
LINES ARE SOUND. PROGRESS IS BEING MADE TOWARD
STRENGTHENED DEMOCRATIC INSTITUTIONS, AND SUSTAINABLE

ECONOMIC GROWTH. BUT THE OUTCOME IS STILL IN DOUBT. PORTUGAL IS NOT YET OUT OF THE WOODS. IN THESE CIRCUMSTANCES, THE LOOMING SHORT-TERM FOREIGN EXCHANGE CRISIS, IS LIKELY TO SEND SHIVERS THROUGH THE SYSTEM.

-- PROGRESS TOWARD RECOVERY WILL BE DISRUPTED. LEGISLATION ESSENTIAL TO INVESTOR CONFIDENCE CURRENTLY BEFORE THE ASSEMBLY COULD BE SIDETRACKED. ECONOMIC COUNTER-MEASURES WILL TAKE TIME TO BE FULLY EFFECTIVE. THE GOVERNMENT WILL TRY TO CONTAIN RESULTING POLITICAL AND SOCIAL UNREST, BUT A CERTAIN AMOUNT IS INEVITABLE WHATEVER THE GOVERNMENT'S RESPONSE.

-- PS COHESION WILL BE DAMAGED. THE INTER-PARTY DEBATE OVER THE PROPER RESPONSE IS BOUND TO LEAVE SOME BLOOD ON THE FLOOR. THE LINES OF THE DEBATE ARE ALREADY APPARENT: FINANCE MINISTER MEDINA CARREIRA AND THE "ECONOMISTS" SUPPORTING MORE BELT-TIGHTENING AUSTERITY; PLANNING MINISTER SOUSA GOMES AND THE "DEVELOPMENTALISTS" OPTING FOR ATTEMPTING TO RIDE THINGS OUT. THE CONTROVERSY WILL GIVE LOPES CARDOSO AND THE PS LEFTWINGERS ANOTHER CLUB TO USE AGAINST THE MODERATE PARTY LEADERSHIP.

-- EFFORTS OF DEMOCRATIC TRADE UNIONISTS WILL BE WEAKENED. MORE AUSTERITY MEANS LOWER WAGES AND HIGHER PRICES FOR THE WORKING MAN. THE COMMUNISTS WILL PUSH THIS THEME AT THE GOVERNMENT'S EXPENSE.
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-- COOPERATION AMONG DEMOCRATIC PARTIES WILL BE DEALT ANOTHER BLOW. THE FOREIGN EXCHANGE CRISIS, DESPITE ITS SHORT-TERM NATURE, WILL BE EXPLOITED BY THE OPPOSITION AS FURTHER EVIDENCE OF GROSS INCOMPETENCE BY THE GOVERNMENT. BOTH THE PSD AND THE CDS WILL PRESS THEIR ADVANTAGE TO THE HILT.

-- THE COMMUNIST WILL BE ENCOURAGED. WITH THE GOVERNMENT UNDER SHARP ATTACK FROM THE DEMOCRATS, THE PCP WILL STEP UP EFFORTS TO STRIKE A DEAL WITH THE SOCIALISTS.

-- THE PRESIDENT'S HAND COULD BE FORCED. IF THE GOVERNMENT, FACED WITH GREATLY INCREASED PRESSURE FROM BOTH LEFT AND RIGHT FALTERED, THE PRESIDENT MIGHT FEEL COMPELLED TO STEP IN TO SAVE THE SITUATION. ANY SIGNIFICANT USURPATION OF POLITICAL PARTY ROLES IN THE PROGRESS WOULD REDUCE PROSPECTS FOR THE STABILIZATION OF DEMOCRATIC INSTITUTIONS.

5. AND A PRELIMINARY CONCLUSION: THE WORSE CASE SCENARIO FLOWING FROM A FOREIGN EXCHANGE CRISIS WOULD BE THE DOWNFALL OF THE SOCIALIST GOVERNMENT, AN ATTEMPT BY THE PSD-CDS TO GOVERN WITH THE INEVITABLE POLARIZATION OF PORTUGUESE SOCIETY THAT WOULD ENSUE. THE SOCIALISTS WOULD BE PUSHED TOWARD THE COMMUNISTS, THE PCP WOULD BECOME MORE

AGGRESSIVE, THE PRESIDENT WOULD COME UNDER MILITARY PRESSURE, AND THE COUNTRY WOULD MOVE AGAIN TOWARD AUTHORITARIAN RULE.

6. THE WORSE CASE SCENARIO, OF COURSE, MAY NOT OCCUR. THERE ARE REAL RISKS, BUT DISASTER IS NOT INEVITABLE. DEMOCRATIC FORCES HAVE RESERVES OF STRENGTH. THERE IS STILL RESILIENCY WITHIN THE SYSTEM. BUT EVEN UNDER THE BEST OF CIRCUMSTANCES, PROGRESS TOWARD A STABLE DEMOCRACY -- OUR PRIMARY POLICY OBJECTIVE IN PORTUGAL -- WILL BE SET BACK.

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7. A FULLER DAMAGE ASSESSMENT MUST AWAIT THE GOP'S ANALYSIS OF THE CAUSES OF THE CRISIS AND INFORMATION ON HOW THEY PLAN TO DEAL WITH IT. THIS WILL BE REPORTED AS SOON AS AVAILABLE.
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